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TAXATION OF QUALIFIED RETIREMENT PLAN BENEFITS

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The fondest and most generous intentions can be waylaid by thoughtless implementation. Despite the most excellent scheme of employer retirement coverage, it is quite possible for the employee to arrive at a penniless old age, and to do so at a high tax cost.

How can it be? Through qualified plans approved by the Internal Revenue Service the employer sets aside tax deductible money, thereby assuring the improvident of retirement sustenance and the more sophisticated of tax deferral and special tax benefits. The employee simply relaxes with fond dreams of that comfortable cottage by the lake bubbling with grandchildren.

So it should be. Yet the end results can be disappointing both in tax effect and retirement security if the employee lacks adequate information on which to make decisions. Careful tax planning is essential for the employee.

First, he must grasp the fact that though qualified plans—both pension and profit sharing—are generally regarded as retirement systems, neither "retirement" nor "retirement age" has a clear definition in the Internal Revenue Code or regulations.

The income tax regulations do specifically provide that pension plans

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are to be established for periodic benefits after retirement,[1] but they do not, and probably cannot, say what retirement really is. Certainly there is no requirement that benefits under qualified plans must be delayed until the employee is truly retired from active employment.

As for "retirement age," we have the H.R. 10 provisions[2] that benefits for owner-employees may not commence before age 59½ nor be delayed beyond age 70½, and regulations, which the courts have questioned, applicable to group term life insurance and sick pay plans[3] that consider retirement age as the voluntary retirement age if benefits are available without actuarial reduction. There is a rule that benefits should commence by age 70½ if retirement has already taken place.[4] However, for the ordinary pension or profit sharing plan, retirement and retirement age are elusive terms, and necessarily must remain so.

The major point of decision for the employee comes upon termination of the employment with which the plan is associated, and this may occur at a quite tender age. The end of active employment is another step, but it, too, is not necessarily the last, for benefits may not actually be received until later. A whole new set of rules comes into play at death. The major points of consideration—termination of employment with an individual employer, retirement from active employment, commencement of benefits, and death—are interrelated and often overlapping, and require the serious attention of anyone who provides advice on pension planning.

The choices to be made are critical. They can only be made after careful calculations of the amounts to be received, other income of the employee, and the tax rates applicable to them.

I. TERMINATION OF EMPLOYMENT

A. *The Life Annuity Contract*

The one vehicle that is truly designed for retirement purposes and which fits in ideally with the Internal Revenue Service attitudes toward qualified plans is the annuity contract (either variable or fixed dollar) of

1. Treas. Reg. § 1.401-1(b)(l)(i).

NOTE: For readers not familiar with federal tax sources, an explanation of the citations used herein may be helpful. All regulations, in abbreviated form, Treas. Reg. herein are found under title 26, Code of Federal Regulations. Other abbreviations in citations are as follows: Rev. Rul.: Revenue Ruling; Rev. Proc.: Revenue Procedure; INT. REV. BULL.: Internal Revenue Bulletin, published weekly by the Internal Revenue Service (used only when citations to the Cumulative Bulletin are not available); CUM. BULL.: Cumulative Bulletin, which is an arrangement, in permanent form, of the contents of the Internal Revenue Bulletin, published twice each year; INT. REV. CODE: Internal Revenue Code (Title 26, United States Code); T.C.: Tax Court of the United States Reports; B.T.A.: United States Board of Tax Appeals Reports.

2. For ease of reference, the term "H.R. 10" is intended to encompass the many amendments to the Internal Revenue Code permitting self-employed persons to enjoy limited benefits under qualified retirement plans.

3. Treas. Reg. § 1.79-2(b)(3); Rev. Rul. 68-385, INT. REV. BULL. 1968-30, 9.

4. Rev. Rul. 66-11, 1966-1 CUM. BULL. 71.

the type sold by a life insurance company. This is not to say that it is *the* best, but that it *fits* best. If, upon termination of employment, the qualified plan distributes a nontransferable annuity contract to an employee, no tax is realized by that employee at the time of the distribution. He may receive such a contract early in his life and realize no taxable income until benefits commence at, for example, age 65.

The deferral of income realization in the case of an annuity contract is effective even though the contract may at any time be surrendered for its cash surrender value.[5] If, in fact, it is surrendered, obviously there is income to the extent of the employee's gain, but mere possession of the policy with the right to surrender does not result in income realization.

Deferral can also be accomplished in a trusteed qualified plan through an arrangement, binding on the employee, by which the trust retains all of the amounts in the employee's account until some specified age. The trust account accumulates income without tax until actual payment to the employee or his beneficiary. In this case, the right to withdraw benefits, unless subject to penalties, will result in constructive receipt. This is not a device frequently used in small plans because few such trusts are equipped to handle accounts of employees who have long since gone into other work. In fact, even large pension trusts often prefer immediate distribution of cash or an annuity contract.

B. *Lump Sum—Capital Gains*

If, of course, the employee prefers a lump sum payable under a qualified plan within one year, this lump sum will be taxed only at capital gains rates,[6] though not for the self-employed. To qualify for capital gains treatment, all amounts held for the employee under the plan must be paid within one taxable year and must be paid on account of the termination of employment. The lure of capital gains, so valuable when rightly used, can lead to unfortunate long range results. The major problem is that the amount so received at an early age is too often regarded as a bonus, and not set aside for retirement. The whole meaning of the retirement program disappears. Even if the lump sum is held for retirement, the income from reinvestment is taxable as it accrues, unless, of course, it is put into the purchase of an annuity contract. Therefore, utilization of the capital gains benefit can be detrimental from a purely tax savings standpoint. On the other hand, the employee must consider the investment return and fixed dollar annuities suffered for many years by comparison with other forms of investments, even after tax. Better returns and new types of annuities are changing this picture.

Although all amounts must be distributed within one taxable year for capital gains purposes, it is not necessary that this distribution coincide with actual termination of employment. It may occur some

5. Treas. Reg. § 1.402(a)-1(a)(2); Rev. Rul. 68-482, INT. REV. BULL. 1968-37, 11.
6. INT. REV. CODE §§ 402(a)(2), 403(a)(2).

years later, in which event, however, increments in the employee's share attributable to the period after termination are taxed as ordinary income.[7]

The gain so taxed—whether or not capital gains rates apply—includes the value of any property distributed by a qualified trust, such as stock or other securities. However, there is an exception for stock of the employer. At the time of distribution, the employee need include in his income only the value of the stock at the time it was contributed to the plan, and may ignore any appreciation in value since that time. Later gain on disposition is taxed to him to the extent it exceeds the amount included in his income at distribution, either as long or short term capital gains, depending on the period of time it was held.[8]

C. *60-Day Election*

When income becomes available, the usual rule is that it is taxable whether or not the taxpayer actually receives it. The mere presence of a choice in the matter inflicts the tax. Under a qualified plan, however, there is a tax-free choice. The employee has a 60-day period after benefits become available in which he may elect to have the amounts paid to him as an annuity, starting at some agreed-upon date, provided that any contract distributed to him is nontransferable.

In a trusteed plan, this annuity purchase or arrangement must be undertaken within the confines of the trust in order to prevent inclusion of the full amount in his income. The employee may not first receive the cash with no restrictions on its use and then purchase an annuity. If he does receive the money and purchase the annuity on his own, he realizes taxable income in the amount of the distribution,[9] because the choice occurs only if he has not received any amounts under the plan.

The 60-day period in fact allows more than one choice. First, the annuity election permits either the distribution of a contract or an arrangement for annuity payments by the trust, with no tax due in either event until actual receipt of benefits; or the whole amount may be received in a lump sum at capital gains rates. Two other possibilities are also available. Part of the payment may be received immediately from the trust, and taxed at ordinary income rates, with the remainder paid out in tax-deferred installments. An even better possibility is that for many purposes the trust may distribute an annuity contract, with no tax, and an additional sum which will receive capital gains treatment.[10] There is clear authority for this procedure only in the case of a trusteed plan. In an annuity plan, the annuity contract could allow a large sum to be paid in the first year with the remainder deferred, but all would be taxed as ordinary income.

The election is good for any of these purposes. The only difference

7. Rev. Rul. 60-292, 1960-2 Cum. Bull. 153.
8. Int. Rev. Code § 402(a)(2).
9. Treas. Reg. § 1.72-12.
10. Rev. Rul. 65-267, 1965-2 Cum. Bull. 141.

is that if anything other than an annuity is elected, the time of receipt dates back to the time the "choice" came into being, *i.e.*, the date the amounts were made available.

Other arrangements can be made to defer benefits, but they must be completed before any amount is due, rather than just before an amount is paid. Therefore, if the employer wishes to allow other options (such as retention of the entire amount or distribution of interest for a period of time and payment of the principal later), they must be a part of the agreement before termination, and an unrestricted privilege of withdrawal defeats this deferral. With this limitation, which need not be overly severe, several variations are possible.

In short, the plan may, through elections properly timed, give the employee a large measure of control over the manner of payments of his benefits.

D. *Distribution of Life Insurance Contract*

The 60-day election also governs the tax treatment of a contract providing life insurance protection distributed by a qualified trust. The employee may, within this 60-day period, elect to convert the policy into a nontransferable annuity contract containing no life insurance protection, and incur no tax on the distribution within that year. The contract must be converted even though it is an endowment life contract in which the cash value has grown larger than the face amount of the contract, and there is no risk element.[11] If the contract is not converted, the cash value, to the extent it exceeds employee contributions, must be taken into income in the year of distribution, though only at capital gains rates if there is a total distribution within one taxable year.[12] The result is the same whether the policy is distributed or surrendered for its cash value.

But what if the employee already has the contract? Although the rulings on conversion have been repeated in later compendiums,[13] the Internal Revenue Service policy position originated at a time when nontrusteed annuity plans were not permitted to provide incidental life insurance protection and therefore did not take such contracts into account. Present regulations recognize the validity of nontrusteed annuity plans with such protection.[14] Under these plans the employee may be allowed to hold the contract during his employment period, so that at termination there is nothing to distribute. The employee already has his annuity contract, and it may contain life insurance. There is no express requirement that he convert this coverage on termination.

What if the conversion goes the other way? If the retirement income

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11. Rev. Rul. 66-322, 1966-2 CUM. BULL. 123.

12. Rev. Rul. 60-84, 1960-1 CUM. BULL. 159; Treas. Reg. § 1.402(a)-1(a)(2). *See also* Rev. Rul. 56-596, 1956-2 CUM. BULL. 288; Rev. Rul. 69-157, INT. REV. BULL. 1969-14, 13.

13. *See* Rev. Rul. 65-178, 1965-2 CUM. BULL. 94.

14. Treas. Reg. §§ 1.403(a)-1(d), 1.403(b)-1(c)(3).

contract held under such a plan is converted to extended term coverage, the Internal Revenue Service holds that the reserve so employed is taxable income at that time.[15] The ruling deals with a section 403(b) plan—a nonqualified plan for employees of a charitable or educational organization—but the same rule would appear to apply to a qualified annuity plan which is set up without a trust. This ruling, by inference, lends support to the assumption that an annuity contract with life insurance protection may be continued after employment is terminated, even though such a contract would have to be converted if distributed by a qualified trust.

E. *Terminating Plan*

It should be noted, perhaps with sorrow, that distributions on termination of a plan do not give rise to capital gains unless there is also termination of employment. Plan termination can bring a sizable tax burden. A possible solution, in some cases, is an arrangement for holding the benefits until each employee terminates his employment. There is at least some reason to suppose that the stamp of qualification remains on the benefits until they are actually paid, even though this occurs well after the plan itself is terminated, at least as a qualified plan. Admittedly there must be some "plan" for holding the benefits until they are paid, and the precise terms of such a plan are not clear; but this delay in distribution is possible at least in theory. To the extent of earnings on or additions to the funds after qualified status is lost, distributions result in ordinary income, but amounts credited as of the last day of qualification may, when distributed as a lump sum, receive capital gains treatment.[16]

The 60-day election of an annuity is not contingent on termination of employment. The regulations simply say that if the employee is entitled to a lump sum and elects within 60 days to receive payments constituting an annuity, no part of the lump sum is then taxable.[17] Therefore, this election is available on distribution pursuant to termination of a plan, or for that matter at any time an amount becomes available under a qualified trust.

F. *Transfer of Account from One Employer's Plan to Another*

Sometimes the termination distribution to an employee who leaves for a new job is consumed simply because there is nothing better to do with the money. There should be better ways of transferring pensions with employment; those who have argued vigorously for compulsory portability of pension coverages have devoted virtually no thought to the possibility of encouraging voluntary portability.

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15. Rev. Rul. 68-648, INT. REV. BULL. 1968-52, 7.
16. Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966), *aff'g*, 44 T.C. 137.
17. Treas. Reg. § 1.72-12.

The Internal Revenue Service has taken a few limited steps in this direction. Although guidance on the means of transferring pension credit from the plan of one employer to another is presently inadequate, there is at least some groundwork in past rulings for future development in this area. We know, for example, that in the case of corporate reorganization, if the plan of one employer is terminated and the coverage taken over by the new plan of the new corporation, the employees are not deemed to have received a distribution under the terminating plan.[18] This is truly a new plan; the old plan is terminated, and the new one is subject to rules such as the restrictions applicable to higher-paid employees. Nothing is deemed paid, however, constructively or otherwise, to the employees, and their retirement protection is maintained.

This, of course, does not help the individual employee who leaves one employer for a new and wholly unrelated employer. There is no reason, in theory, why the first employer could not agree with the second to transfer this employee's share directly, so that the benefits are not then made available to him. No ruling so far has dealt with this particular situation as it affects the ordinary employee. Ordinarily, if cash is distributed to the departing employee, he must be taxed immediately even though he immediately contributes this amount to the plan of the new employer.

Here again, the annuity contract proves from an administrative standpoint to be the ideal vehicle for a continuing pension system. There is no tax on distribution of an annuity contract, which would appear to be easily incorporated in any new plan. One problem is that the distributed annuity contract must be nontransferable. This poses no problem if the new employer's plan is a nontrusteed annuity plan which may simply assume payments for the old contract. The Service has held that this can be done in the cases under section 403(b) plans,[19] and there seems to be no reason why the same rule would not apply under section 403(a). In such a case, if the contract was transferable at the outset, it must be made nontransferable under the new arrangement.[20] In a qualified H.R. 10 plan, an annuity contract may be transferred from a pension trust to a bank custodian in another qualified plan covering the same individual.[21] In so holding, the Service does not discuss the rules against transferability, and perhaps it could be said that if the contract had been distributed to the employee, he would no longer have been able to transfer it to a new plan, or in any event to a new trust. This would be a distortion of the purposes of the nontransferability rule, even though in accordance with a literal reading of the statute.[22]

18. Rev. Rul. 67-213, 1967-2 CUM. BULL. 149.

19. Nonqualified plans for employees of certain charitable organizations and public schools; Rev. Rul. 66-254, 1966-2 CUM. BULL. 125.

20. Rev. Rul. 68-33, 1968-1 CUM. BULL. 175.

21. Rev. Rul. 68-160, 1968-1 CUM. BULL. 167.

22. INT. REV. CODE § 401(g).

Basically, the rulings have been concerned with transfer from one plan to another of the same employer, and they hold that no income is realized by the employee because of such change[23] unless amounts are made available to the employee without agreement for reassignment to the new plan. Transfer to a new employer involves problems of compatibility with a different plan. Therefore, though in theory there may be assumption of the coverage by the new employer, in practical fact it may be impossible.

Although we might have wished for more from the government, the author suggests that this is a subject proper for responsible thought within private business. The major question is not whether, but how pension credits may be transferred from one employer to another. This is an extremely difficult problem in view of the diversity of pension plans. A greatly encouraging step is the development of standardized plans, particularly for small employers. Now that the Internal Revenue Service has provided guidelines for approval of these plans,[24] it is the author's hope that efforts will be made for easy transfer of credits from one employer using such a plan to another. The standardized plan system will, for the first time, permit a broader type of plan design that can take account of transfer of credits. With the variable plans, this will be more difficult but certainly not impossible. After there has been some experience with these plans, improvements will be possible.

G. *Taxation of Benefits before Termination*

Under a pension or annuity plan there would normally be no distributions short of termination of employment or termination of the plan, except for some limited overlapping for employees who stay on after retirement age. Profit-sharing plans, however, need defer income only for a "period of years." If the employee can elect to receive the amount held by the plan for him, he is deemed to have received income in that amount unless there are conditions on withdrawal which overcome the presumption of constructive receipt. Penalties on withdrawal, such as loss of benefits before a pre-determined date or loss of rights to continue to participate in the plan, are considered such conditions.[25] The rules here are much the same as those applicable to the right of the employee to have employer contributions go either into the plan or directly to him at the time of such contributions, or, for that matter, the right to distributions after termination of employment. There may be withdrawal without interest of the employee's own contribution, withdrawal with interest on total discontinuance of participation in the plan, or refund by the employer of all employee contributions.

23. *See* Rev. Rul. 55-368, 1955-1 CUM. BULL. 40; Rev. Rul. 55-317, 1955-1 CUM. BULL. 329; Rev. Rul. 55-427, 1955-2 CUM. BULL. 27.

24. Rev. Proc. 68-45, INT. REV. BULL. 1968-53, 28.

25. Rev. Rul. 55-423, 1955-1 CUM. BULL. 41; Rev. Rul. 55-424, 1955-1 CUM. BULL. 42; Rev. Rul. 55-425, 1955-1 CUM. BULL. 43; Dillis C. Knapp, 41 B.T.A. 23; Estate of A. M. Berry, 44 B.T.A. 1254.

Life insurance provided by a qualified plan of pension or profit sharing is a taxable benefit, included in income each year at values set forth in Revenue Ruling 55-747.[26] Often, to avoid the problems involved in having the employees report this amount in their income, the employee contributions will be directed to this coverage. However, unless the plan expressly specifies that the employee contribution is to be used in this manner, it will be deemed not to purchase the life insurance protection and the employee will be required to include in his income the value set forth in the ruling.[27]

The incidental life insurance protection that may be provided through group term insurance purchased by a qualified trust must be included in the current income of the employee, even though the identical protection purchased outside of the trust would be tax exempt up to $50,000 of coverage. This treatment was first provided by ruling and later incorporated in section 79 of the Code, for reasons which have never been made completely clear. There is no provision in the Code or in rulings for the valuation of this protection and some writers contend that the employer's cost, rather than values set up under Revenue Ruling 55-747, should be used. The prevailing view, and one which seems to be accepted by the Internal Revenue Service, is that the ruling does apply. It is quite clear, in any event, that in most cases group term insurance should be provided in a plan outside the qualified trust, because if paid directly by an employer coverage up to $50,000 is exempt under section 79.

Health insurance premiums under a qualified plan are also deemed paid by employer—not employee—contributions, in the absence of express provision in the plan.[28] This, of course, is to the employee's benefit because, under section 106, he is not taxed on the employer's contribution to such coverage. Furthermore, to the extent of his contribution to disability coverage, the employee would obtain no medical expense deduction, and the contribution made by the employee for health insurance protection of any kind is not treated as consideration for retirement benefits.

We must pause here to note that the Treasury's position on qualified plan health coverage defies comprehension. Although the Regulations quite clearly permit sick pay benefits, excludible to $100 per week, under both pension and profit sharing plans, a recent ruling denies any employee medical expense exclusion for amounts paid by a profit sharing plan.[29] The reason, the ruling says, is that a profit sharing plan is not a health plan, which is hardly consistent with provisions in the Regulations for sick pay benefits. In any event, employee contributions allocable to the health benefits under such a plan would not remedy that situation. There

26. 1955-2 CUM. BULL. 228; INT. REV. CODE § 72(m)(3).
27. Rev. Rul. 68-390, INT. REV. BULL. 1968-30, 18.
28. Treas. Reg. § 1.72-15(c)(2).
29. Treas. Reg. 1.72-15(c)(3); Rev. Rul. 69-141, Int. Rev. Bull. 1969-13, 6.

is, in short, very little reason to designate employee contributions expressly for accident or health benefits.

II. RETIREMENT

A. *Final Arrangement with Employer*

There comes a time when the employee has reached what he considers to be retirement age, and has entered those conditions under which he no longer intends to be bound by employment. This is a time at which his termination of employment is deemed truly to be for retirement purposes rather than merely to seek out new regular employment. In what is assumed to be the typical case, the employee simply settles down and starts to receive his monthly pension checks; but more and more we are finding that this is far from typical. Some type of employment continues in a great many cases, and income derived from the new employment may be substantial. Retirement often provides the means for establishing high risk businesses, the opening of private law offices, the establishment of various consulting services, or the expansion of a hobby into a profit-making enterprise. Therefore, so-called retirement may be nothing more than another in the series of points of decision in his retirement pattern.

From a purely mechanical standpoint, the choices are the same as those to be made on termination at any age. The forces that work on those choices, however, can be quite different. The employee is now far more able to make a sound judgment on the disposition of his retirement plan proceeds. Also, he probably is in a better position, as he nears retirement, to enter into arrangements with his employer. The decisions are far from obvious.

B. *Capital Gains*

Here, once again, is the opportunity for taxation of the lump sum at capital gains rates, either through surrender of an annuity contract distributed in the year[30] or through total distribution of trust proceeds. Once more, the employee must be reminded that the attraction of capital gains may be quite misleading. For example, if the retirement benefit is fairly modest, the retired employee could find a burdensome capital gains tax in one year on amounts which would be largely tax exempt if received as an annuity during the years after age 65, in which he and his wife would have extra exemptions and the retirement income credit. Even if from a long-range view the lump sum distribution results in an overall lower tax, the burden of that tax in one year, as against a tax spread over a period of years, could be quite heavy. In addition, the tax advantage, if it does exist, must be carefully measured against the needs of the employee. In some cases it would be most unfortunate if the em-

30. Rev. Rul. 59-401, 1959-2 CUM. BULL. 121.

ployee should take his entire retirement benefit and invest it in a personal business which might be unsuccessful, particularly if his health were to fail.

Nonetheless, for the retiree with a high income, the capital gains route could result in substantial tax savings. There are solid reasons, apart from taxes, for a decision to take down a large cash amount in appropriate cases. For example, many of the new retirement residences require a large initial deposit. Certainly some retirement businesses are sound and justify the payment of a large capital amount.

In these cases it is usually desirable to have a cash amount as well as a basic assured income in excess of Social Security, and often this can be conveniently arranged. For example, if the employee has received an annuity contract from some earlier employer, he may rely on this contract for periodic income and take the benefits from his most recent employment in a lump sum at capital gains rates. (It is at this point too late to take the proceeds from the earlier contract as capital gains, because this can only be accomplished through surrender in the year of distribution of the contract.[31]) Also, the Service has ruled that if a plan distributes an annuity contract and other funds, the annuity contract need not be surrendered in order to realize capital gains on the other funds distributed by the trust.[32] Except through this arrangement, it is not possible to receive capital gains on a portion of a single employer's plan benefits and to defer receipt of the remainder.

C. *Further Deferral*

Another decision to be made is the time of commencement of benefits. The combination of accrued vacation pay and non-qualified deferred compensation falling within the first year of retirement could make it desirable to delay commencement of the qualified plan benefits for a year or more. In addition, if the former employee expects income from his retirement occupation, retirement income should be put off unless, of course, it is needed to assist the retiree in the establishment of his new business.

Arrangements for delay are limited. Revenue Ruling 66-11[33] provides that any qualified plan must provide for the commencement of benefits on some specified event, such as retirement or the attainment of a stated age not later than 70½. The ruling permits some latitude but does require a clear provision on commencement of benefits; the retiree may not select any time he chooses. Of course, within the area of election available to him, if he has the right to take down the proceeds in a lump sum, those amounts are made available to him and are taxable within that year unless he elects an annuity.

31. Rev. Rul. 55-298, 1955-1 CUM. BULL. 394.
32. Rev. Rul. 65-267, 1965-2 CUM. BULL. 141.
33. 1966-1 CUM. BULL. 71.

Deferral after retirement ordinarily requires pre-retirement arrangements with the plan. The qualification of a pension plan allowing individual variations in commencement of benefits is by no means certain, though it does seem possible to arrange for distribution of an annuity contract to commence two or three years after retirement. A profit sharing plan, however, may provide that the employee has the right to elect, prior to the time amounts would otherwise be due, to have those benefits retained by the trust.[34]

If the retired employee has an annuity contract with payment commencing at, age 65, for example, it might be that he can exchange this annuity contract for one commencing at age 70, an exchange which would be nontaxable.[35] The tax-free exchange provisions apply to an endowment contract only if it is exchanged for another contract providing for payments which begin at a date not later than the date when the payment would have begun under the original contract. There is no such provision in the case of a pure annuity contract nor in the case of an endowment contract exchanged for an annuity contract, being that the tax exempt death benefit is enlarged by delay in payments under an endowment contract whereas there are no tax free death benefits under an annuity contract as such.

The right to exchange annuity contracts is also important in enabling the employee to substitute a variable annuity if he so desires. A variable annuity is an annuity contract,[36] and the exchange of a fixed dollar annuity contract for a variable annuity is a tax free transaction under section 1035.[37]

But does the rule requiring that the contract distributed by a qualified plan be nontransferable prevent such an exchange in cases such as these? The regulations provide that the contract may not be transferred to any person "other than the issuer thereof."[38] This was originally taken to mean that the employee always had the right to surrender, but if taken literally the words would also permit transfer in exchange for another contract with the same issuer. Clarification is needed here. A guess at this point, based on past Treasury inclinations, is that an exchange for a contract with a later starting date would be opposed, but an exchange for a variable annuity contract issued by the same company and with the same starting date would be permitted. Substitution of variable annuities for fixed annuities has never troubled the Treasury very much. Whether fixed or variable, the annuity contract has a "definitely determinable benefit" and both can be provided together as a package plan considered as a single contract.[39] It is not too much of a jump to say that an exchange of an

34. Rev. Rul. 60-292, 1960-2 Cum. Bull. 153.
35. Int. Rev. Code § 1035.
36. Rev. Rul. 68-116, 1968-1 Cum. Bull. 177.
37. Rev. Rul. 68-235, 1968-1 Cum. Bull. 360.
38. Treas. Reg. § 1.401-9(b)(3).
39. Rev. Rul. 68-647, Int. Rev. Bull. 1968-52, 6.

ordinary annuity for a variable annuity of the same company is but an extension of the original contract. Of course, if the employee elects a lump sum and purchases another annuity contract, he may select any terms he wishes because the new contract is then his own individual purchase and no longer has any relationship to the qualified plan.

III. THE BENEFIT PERIOD—ANNUITIES

When annual payments actually begin under the plan or annuity contract, the benefits are taxed as paid under the contract even though the beneficiary may have the right to commute further payments and receive a lump sum of the remainder. Should he actually receive such a lump sum in a later year, he would not be entitled to capital gains treatment.

If the employee has made no contribution, all of the amounts received are taxable. If he has, however, his contribution is his basis in the contract and is recoverable tax free under one of the formulas set forth in section 72 of the Code.

It cannot be assumed that because of the trend toward noncontributory plans we are no longer concerned with computation of the employee's cost or other consideration of the contract under which he is receiving benefits. For example, the purchase of an annuity after receipt of a lump sum at capital gains rates provides a new basis. Similarly, distribution of a contract containing life insurance protection provides a basis in the amount of the cash value that was taxed to the employee at the time of distribution. If the plan is nonqualified and not covered by I.R.C. section 403(b), the value of an annuity contract purchased by an employer and distributed in that year to the employee is income to the employee when purchased, if it is nonforfeitable.[40] The amount so included in income is recoverable basis.

A. *Life Insurance Cost as Basis*

Added to this cost or other consideration (or basis) other than in H.R. 10 plans is the amount which was included in the employee's income because of the provision in qualified plans for current life insurance protection. Since he was taxed on this amount, it is treated as his contribution to the plan. This tax benefit is complicated, perhaps beyond its value to the taxpayer, but whatever benefits come from it should not by reason thereof be lost.

The Internal Revenue Code states only that the cost of life insurance protection shall not be deductible under H.R. 10[41] and shall not constitute a part of the employee's basis for a self-employed person. The inference of this exception is that the addition to basis or employee cost is allowed in other cases. The regulations specifically provide that this cost of

40. Elliott C. Morse, 17 T.C. 1244; Charles Wilson, 39 T.C. 362.
41. INT. REV. CODE § 72(m)(2).

current insurance protection is part of the ordinary employee's basis, but only with respect to retirement benefits under the contract which provides the protection.[42]

What exactly is meant by "the contract which provides the protection" has been a subject of some debate within recent months. A clear dividing line is term insurance protection provided by a separate contract in a qualified plan. Such a contract provides no retirement benefits, and no portion of the cost of such insurance is included in the employee's tax-recoverable basis.[43] The difficulty arises in those cases in which the plan involves more than one contract, some providing both life insurance and retirement coverages, and in the use of side funds. The rule is that only the cost of insurance under the contract providing retirement income is allowed as part of basis.

Coverage purchased in units may be treated together as a single package if each unit contains both life insurance and annuity coverage. Thus in the case of a plan funded with retirement income contracts, including additional contracts to cover successive increases in pay, all are considered as a single contract for purposes of section 72.[44] Similarly, an interrelated variable annuity and fixed-dollar annuity has been accepted by the Service as a single contract for this purpose.[45] Taking these interrelated contracts as a single contract, one may lump together all of the cost of insurance under any or all of them and set it off against the total retirement income as paid. If the group of contracts cannot be related—and precisely what rules apply to the relationship is not entirely clear—then the life insurance premiums may only be applied in reduction of taxable amounts received under the specific contract which provides the protection.

Again, term insurance will never be included in such a relationship. The Internal Revenue Service has held that the relationship is also lost if the contract providing the protection is surrendered by a trust and the amount used to purchase an annuity contract.[46] This form of substitution has been said by the Service to have wiped out any advantage of the employee's insurance cost. This rule has not thus far been applied to the cases in which the contract providing the life insurance protection is converted into a pure annuity contract, or even to the slightly different case in which a contract containing life insurance protection is exchanged for a pure annuity. In these cases—until further bad news comes our way—the employee should consider the life insurance values on which he was taxed under such contracts as part of his consideration for the retirement benefit eventually received.

42. Treas. Reg. §§ 1.72-2(a)(3) example 7, 1.72-8(a)(1), 1.72-16(b)(4). Similarly, this cost is part of the employee's basis in a section 403(b) plan. Rev. Rul. 68-304, 1968-1 CUM. BULL. 179.

43. Treas. Reg. § 1.72-2(a)(3)(iv) example (6).

44. Treas. Reg. § 1.72-2(a)(3)(iv) example (7).

45. Rev. Rul. 68-647, INT. REV. BULL. 1968-52, 6.

46. Rev. Rul. 67-336, 1967-2 CUM. BULL. 66.

A separate investment fund which is set up in the same plan which provides retirement income contracts is looked upon as a separate program.[47]

One must keep in mind that amounts contributed by an employee which are specifically designated for accident or health protection, including double indemnity, are not treated as part of the cost or consideration for retirement benefits. The same is true in an individually purchased contract.[48]

B. *Recovery of Basis*

If the employee will recover his entire basis within the first three years of payments under the plan, no part of the payments is included in his income until he has made a full recovery.[49] Should this result in the exclusion of all or most of the benefits paid over these three years, he may find it to his advantage to utilize the income-averaging provision of section 1301 of the Code with respect to fully-taxable payments received in the fourth year. In order to use the averaging provision, the income during the year of averaging must exceed the average income of the previous four years by one-third. The four-year period would include, in the usual case, the final year of employment, which is probably a high income year, but if there is no taxable income for the other three years, the opportunity to average may be present. The presence of these factors may suggest that the annuitant consider deferring any other income to the fourth year, to the extent that he can do so.

If the employee's basis is greater than the first three years' payments, he computes an exclusion ratio based upon the allocation of his contribution to the remaining period of payment under the contract. For the straight life annuity, the allocation is based upon his life expectancy; for a joint and survivor annuity, it is based on tables computed upon joint lives. A refund feature, as in the case of a life annuity with ten years certain, requires allocation of a portion of the employee's contribution to that refund feature.[50] That amount is then excluded from the income of the survivor.

The exclusion ratio for a variable annuity is fixed just as in any other case. The investment in the contract is adjusted for the refund feature, then divided by the number of anticipated payments. Any amount received during the year in excess of that exclusion is subject to tax. If the payment for any year is less than the exclusion, the deficiency is added to the employee's investment in the contract.[51]

If the plan provides for retention of the full amount of the participant's share under an agreement to pay interest—assuming that the plan can make this arrangement, which is presently doubtful—the inter-

47. Treas. Reg. § 1.72-2(a)(3)(iv) example (8).
48. Rev. Rul. 55-349, 1955-1 CUM. BULL. 232; Wong Wing Non, 18 T.C. 205.
49. INT. REV. CODE § 72(d)(1).
50. INT. REV. CODE § 72(c)(2).
51. Treas. Reg. § 1.72-2(b)(3).

est is fully taxable when received, with no offset for any amount of employee contributions, and the principal amount is not taxable until it can be withdrawn. A right of surrender, or any right to anticipate the full amount, will probably bring it into income even though there is some loss of benefits on withdrawal.[52] The Service may be depended upon to seek ways of bringing this amount into income. For example, the Service has held that a savings account which limited withdrawal of interest, but not of principal, did not prevent constructive receipt of the interest.[53]

IV. DEATH BENEFITS

Death benefits under qualified plans demand the most careful attention, for they involve tax decisions by both employee and beneficiary. Available are the $5,000 employee death benefit exemption, capital gains on lump sums, and recovery of the employee's own contributions.

A. *Life Insurance*

The exemption under section 101(a) for proceeds of a life insurance contract held by a qualified plan applies only to the risk portion, the amount of the proceeds in excess of the cash value at death.[54] The cash value is then subject to the $5,000 employee death benefit exemption under section 101(b) of the Code. This benefit applies whether payment is to the employee's estate, to a trust, or to a named beneficiary.[55] There is further deducted from the taxable proceeds any amount of contributions made by the employee during his lifetime, including the value of current life insurance protection on which he was taxed during his employment.

A very sizable portion of the death benefit under a life insurance contract is, therefore, tax exempt. The remainder, if all benefits are distributed within one taxable year, is taxed at capital gains rates.[56] If, on the other hand, an election is made to receive the benefits in installments —and the beneficiary may do so within 60 days—the widow's exclusion is applicable to the annual income attributed to the portion which was excluded under section 101(a) of the Code, which is the pure insurance death benefit.

B. *Special Cases of Life Insurance Contracts*

Two special cases must be noted. The first is that if the life insurance contract had been distributed to the employee at the termination of his employment, and he was taxed on the amount of the cash surrender

52. Treas. Reg. § 1.451-2(a)(2).
53. Rev. Rul. 68-586, INT. REV. BULL. 1968-45, 11.
54. Treas. Reg. § 1.72-16(c)(2).
55. Treas. Reg. § 1.101-2(a)(i).
56. Treas. Reg. § 1.402(a)-1(a)(6)(1).

value at that time, then the life insurance contract became his own property and the entire proceeds are exempt under section 101(a).[57] On the other hand, it sometimes happens that the trust purchases life insurance on the life of the employee and makes itself the beneficiary under the policy without commitment to pay the proceeds, as such, to the employee's beneficiary. Therefore, during the lifetime of the employee, he is not taxed on any amount of current life insurance protection. At death no part of the proceeds is excludable under section 101(a).[58] Obviously, he also has no recoverable basis on account of the premium payments made by the trust, since they were never included in his income. However, the $5,000 death benefit does apply as does the provision for capital gains treatment if distribution is made within one year.

C. *Death after Retirement*

Although the capital gains provisions apply in terms of lump sum distributions, it is possible to receive capital gains treatment at death even though some benefits have commenced under the plan during the lifetime of the employee.[59] The beneficiary must, of course, receive a lump sum distribution of all remaining benefits in one year. On the other hand, if there has been a total distribution during the life of the employee, it is not possible, the Service contends, to have another total distribution at death. Therefore, when an annuity contract and a side fund are distributed by a trust to an employee, who treats the side fund as a capital gain and is required to report income on account of the annuity only when payments commence, there is no further possibility of a lump sum distribution at death. The decision of the widow to commute the value of the survivor benefits brings to her ordinary income which is taxable within that year.

D. *Annuity Contract and Investment Fund*

This treatment of an annuity-side fund combination involves some difficult concepts and possible inconsistencies. The Service first ruled that there could be capital gains treatment of the side fund even though the annuity was held for payment out of the proceeds over a period of years.[60] This ruling was based on the theory that all of the proceeds of the plan had been distributed, including the contract and the funds, but that because of section 72 the value of the contract could not be included in income until benefits were actually received.

The Internal Revenue Service then ruled that the annuity contract could be surrendered within the same year of its distribution and the

57. Rev. Rul. 63-76, 1963-1 CUM. BULL. 23.
58. Treas. Reg. § 1.72-16(c)(4).
59. Treas. Reg. § 1.402(a)-1(a)(6)(ii).
60. Rev. Rul. 65-267, 1965-2 CUM. BULL. 141.

benefits taxed at capital gains rates. If however, it were distributed by the trust, under a similar arrangement, and surrendered in some later year, the ordinary income rates applied.[61] Similarly, surrender at death was held to result in ordinary income because the proceeds no longer bore the stamp of proceeds under a qualified plan.[62] Rather, they were payments under a contract that had itself been distributed by a qualified plan. The result was completely to deny the capital gains treatment with respect to any portion of the benefits under this contract.

This system of combining a lump sum at capital gains with deferred income can be confusing because of the widely different results in plans of payment that are quite similar in appearance. If, for example, the trust distributes cash and simply arranges to pay out the remainder as an annuity, capital gains rates are not available with respect to the lump sum because there is no total distribution. At death, however, a total distribution may be received at capital gains rates because it is made from an exempt trust. If the trust distributes cash and an annuity contract, there are capital gains on distribution, but none at death because the annuity contract no longer is part of the plan.

This arrangement for combining a lump sum at capital gains rates and deferring the income represented by the annuity contract has distinct advantages, and perhaps one should not argue with the offsetting disadvantages. On the other hand, if the annuity contract is distributed with no side fund, denial of the benefit of capital gains at death seems unjustified and inconsistent with the Regulations, though the rulings appear to dictate this result.

E. *$5,000 Death Benefit*

Although most death benefits under qualified plans do qualify for the $5,000 death benefit exclusion, it is not applicable to certain survivor annuities. The benefit may be in the form of an annuity contract for the survivor, but it may not be a continuation of an annuity which had been commenced prior to the death of the employee if the $5,000 exclusion is to apply. In such a case the employee's exclusion ratio continues through the contract. Further, the $5,000 exemption for nonforfeitable death benefits is not available to the beneficiary under a section 403(b) plan covering public school employees,[63] or (for either forfeitable or nonforfeitable benefits) to the self-employed under H.R. 10.

F. *Estate and Gift Taxation*

Qualified plan benefits other than under H.R. 10 are exempt from both gift and estate tax to the extent the benefits are attributable

61. Rev. Rul. 65-268, 1965-2 CUM. BULL. 143.
62. Rev. Rul. 68-287, 1968-1 CUM. BULL. 174.
63. Rev. Rul. 68-294. 1968-1 CUM. BULL. 46.

to employer contributions.[64] This exemption also applies to nonqualified annuity benefits of certain charitable organizations, though not to such plans of public schools.

Amounts attributable to employee contributions, however, are not exempt. An irrevocable election of a survivor option, for example, results in gift tax liability to the extent of the value of the benefits attributable to employee contributions. Happily, the gift tax liability, which could be productive of great hardship, is almost completely ignored by both the Internal Revenue Service and the taxpaying public. Imposition of a gift tax seems wholly unnecessary, because the amounts so taxed would be subject to inclusion in gross estate and the gift tax paid would be allowed as a credit.

There is no avoiding the estate tax on the employee-paid portion by an attempted transfer before death. The Internal Revenue Code provides for inclusion of amounts attributable to employee contributions even though the survivor benefits had been assigned or designated long before the employee's death. For this purpose, the amounts paid by the employer for life insurance protection, and included annually in the income of the employee, are treated as employer contributions, so that proceeds of a policy held by a qualified plan are exempt under section 2039(c) of the Code[65] unless there are actual employee contributions.

Neither gift nor estate tax exemption applies to benefits which had been made available to the employee prior to his death. Therefore, amounts which could have been withdrawn go through the employee's taxable estate.

This subject is more extensively treated in a great many articles and these few remarks should be regarded merely as a reminder of the broader implication of this other field of federal taxation.

V. Conclusion

Advisers on pension plans are necessarily most seriously concerned with problems of qualification and employer deductions. The income taxation of the benefits is an individual matter, in which the employee often acts alone, unaided, and to his detriment. To a large degree, this is necessary. Obviously, the employer should avoid pressures on employees with respect to use of pension money when it is distributed. However, the employer, the trust, and the insurance company all have available the best legal talents. The employee should at least be advised that his retirement benefits represent a sizable investment with important legal implications.

We have come to realize most forcibly in the last few years that employee satisfaction with retirement coverage is essential to the future

64. INT. REV. CODE §§ 2039(c), 2517(b).
65. Treas. Reg. § 1.402(a)-1(a)(6)(1). Rev. Rul. 67-311, 1967-2 CUM. BULL. 329.

of private pension systems. The fact that his own actions may have produced an unsatisfactory result will not help overcome bitterness over unmet needs. The energies of pension advisers, both financial and legal, must be given not only to what goes into a pension plan but also to what comes out of it.